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No. 74-22

In the Supreme Court of the United States

OCTOBER TERM, 1974

IVAN ALLEN COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

ROBERT H. BORK,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

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The issue raised by the petition is whether, in determining if a corporation has accumulated its earnings and profits beyond the reasonable needs of its business within the meaning of Section 533(a) of the Internal Revenue Code of 1954, the amount available to meet the corporation's reasonable business needs should be ascertained by reference to marketable securities at their fair market value, as the decision below held, or at their historical cost.

The pertinent facts, as the parties stipulated, are that petitioner had reasonable business needs for operating capital of $1,198,309 and $1,455,222 at the close of its taxable years ended June 30, 1965, and June 30, 1966, respectively. In the taxable year ended June 30, 1965, petitioner owned 11,140 shares of Xerox Corporation stock with a cost basis of $116,701 and a

fair market value of $1,573,525 and Xerox convertible debentures with a cost of $30,625 and a fair market value of $48,424. In its taxable year ended June 30, 1966, petitioner owned 10,090 shares of Xerox stock having a cost basis of $102,479 and a fair market value of $2,479,617 and Xerox convertible debentures with a cost of $30,625 and a fair market value of $69,768 (R. 67).[1]

If petitioner's marketable securities (consisting largely of the greatly appreciated Xerox securities) were taken into account at cost, its net liquid assets (current assets less current liabilities) would have been equal to its reasonable business needs at the close of the taxable years at issue. However, if petitioner's marketable securities were taken into account at their fair market value at the end of the taxable years at issue less the cost of converting them to cash, its net liquid assets would have been substantially in excess of its reasonable business needs. Under the latter analysis, petitioner's net liquid assets were respectively $2,235,029 and $3,152,009 for the taxable years at issue (R. 7-8), or more than $1,000,000 in excess of its reasonable business needs for 1965 and more than double its reasonable business needs for 1966.

On audit, the Commissioner of Internal Revenue valued petitioner's Xerox holdings at fair market value. He therefore determined that petitioner's net liquid position exceeded its reasonably anticipated business needs. Accordingly, the Commissioner assessed an accumulated earnings tax against petitioner. In this refund suit, the district

[1]"R." references are to the record appendix in the court of appeals.

court held that petitioner's marketable securities could only be taken into account at cost, and entered judgment for petitioner (Pet. App. II, A9-A13). The court of appeals reversed, holding that "the proper standard for determining the amount of taxpayer's liquid assets is the fair market value less the expense of converting them into cash." It remanded the case for a factual determination whether the purpose for petitioner's unreasonable accumulation of earnings and profits was to avoid income taxes on its shareholders (Pet. App. I, A3-A8).

1. Section 531 of the Code imposes an accumulated earnings tax on every corporation "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders * * * by permitting earnings and profits to accumulate instead of being divided or distributed." See Section 532(a). Section 533(a) in turn provides that "the fact that the earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary." While the statute makes no reference to a corporation's liquid assets, it is well settled that the determination whether a corporation has permitted earnings and profits to accumulate beyond the reasonable needs of its business requires examination of the extent to which the corporation's liquid assets exceed its reasonably anticipated business needs. *Smoot Sand & Gravel Corp.* v. *Commissioner*, 274 F. 2d 495 (C.A. 4), certiorari denied, 362 U.S. 976. When the liquid assets are marketable securities, their value should be determined

on the basis of their then realizable amount, not their original cost, since it is their current value that controls the company's liquidity.

In *Helvering* v. *Nat. Grocery Co.*, 304 U.S. 282, this Court held that unrealized losses in the value of securities owned by a corporation is evidence to be considered in determining whether the corporation has accumulated earnings in excess of its reasonable needs. The court of appeals properly recognized that the teaching of *Nat. Grocery* applies as well to the converse situation presented by this case. Here, petitioner's liquid assets have appreciated in value rather than depreciated. But in order to determine whether petitioner's available financial resources exceeded its reasonably anticipated business needs, the court of appeals correctly concluded that the fair market value of petitioner's liquid assets represented a far more accurate measure of its available resources than their historical cost. Accord, *Henry Van Hummell, Inc.* v. *Commissioner*, P-H Memo T.C. para. 64,290, affirmed 364 F. 2d 746 (C.A. 10), certiorari denied, 386 U.S. 956; *Golconda Mining Corp.* v. *Commissioner*, 58 T.C. 139, supplemental opinion, 58 T.C. 736, on appeal C.A. 9, Nos. 72-3202, 73-1161, and 73-1162. See also Note, *Accumulated Earnings Tax: Should Marketable Securities Be Valued At Cost Or At Fair Market Value In Determining The Reasonablness of Further Accumulations Of Income?*, 40 Brooklyn L. Rev. 192 (1973).

2. Petitioner urges (Pet. 6-9) that the decision below conflicts with *American Trading & Production Corp.* v. *United States*, 362 F. Supp. 801 (D. Md.), affirmed *per curiam* on the opinion of the district court, 474 F. 2d 1341 (C.A. 4). (See Pet. App. III, A14-A15.) There,

a corporation whose accumulated earnings were approximately $10,000,000 and whose anticipated business needs totaled approximately $12,000,000 was held not to be liable for the accumulated earnings tax despite the fact that it owned marketable securities that had "explosively increased in value" from an original cost of $5,593,319 to a current market value in excess of $100 million (362 F. Supp. at 808-809, 811). The district court excluded those securities from consideration in determining whether the corporation had permitted earnings to accumulate in excess of its reasonable business needs on two grounds: (1) that the appreciated securities constituted the corporation's original capital; and (2) that the securities laws might have created some impediment to marketability. The court of appeals affirmed *per curiam*. *See also Harry A. Koch Co.* v. *Vinal*, 228 F. Supp. 782, 784 (D. Neb.), to the same effect.

Although the court of appeals in this case noted (Pet. App. I, A5 n.2) that these were arguable grounds for distinguishing *American Trading*, we agree with petitioner (Pet. 8), that it is irrelevant that the appreciated property held by the taxpayer in that case was original capital. In our view, appreciated property must be valued at fair market value whether or not it is part of a corporation's original capital. However, despite the irrelevance of this factor, it is not clear that the Fourth Circuit would have decided this case for the taxpayer because the appreciated stock held by petitioner was not part of its original capital. Moreover, unlike the situation in *American Trading*, there are no impediments to marketability of the appreciated securities held by petitioner as a result of the securities laws. There is accordingly no conflict of decisions warranting review by this Court.

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

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